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No. 215

In the Supreme Court of the United States

OCTOBER TERM, 1932

E. G. PALMER, PETITIONER

v.

MRS. AGNES B. MCGRAWL BENDER, ADMINISTRATRIX OF THE ESTATE OF JACOB O. BENDER, LATE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF LOUISIANA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the District Court for the Western District of Louisiana (R. 98–116) is reported in 49 F. (2d) 316. The opinion of the Circuit Court of Appeals (R. 424–429) is reported in 57 F. (2d) 32.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 26, 1932. (R. 429.) A petition for rehearing filed April 12, 1932 (R. 430) was de-

nied April 23, 1932 (R. 435). The petition for certiorari was filed July 12, 1932. Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether instruments, executed by partnerships of which petitioner was a member, effected a sale or assignment of oil and gas leases, or were merely subleases upon the basis of which the partnerships would be entitled to allowances for depletion of their respective interests.

STATUTE AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra,* pp. 13–15.

STATEMENT

This case is one of forty-five related cases which were by stipulation consolidated for trial. (R. 355–360.) The case was tried to the court without a jury (R. 26), and was submitted upon stipulations and agreed statements of evidence (R. 92, 178, 320, 322, 324, 335).

The petitioner was a member of two partnerships known as the J. E. Smitherman Special Account and the George O. Baird Partnership. The partnership of J. E. Smitherman Special Account was formed in 1919 with the petitioner having a 15⅝ per cent proportionate interest. The partnership acquired oil and gas leases on 26,000 acres

of land in the vicinity of Haynesville, Louisiana, in the name of J. E. Smitherman in whose name all subsequent contracts were made. (R. 29–30.)

During 1919, 1920, and 1921, several wells were drilled but no oil was discovered until on March 30, 1921, a producing well was completed in a discovery area located on four of the leases. Exhibits "H" (R. 198), "I" (R. 204), "J" (R. 209), "K" (R. 213), (R. 31). On April 23, 1921, the partnership, by an instrument in writing, transferred to the Ohio Oil Company 120 acres of the 160-acre tract on which the producing well was located. The pertinent parts of the instrument were as follows (R. 31–33):

> * * * in consideration of the sum and price hereinafter set forth, he [Smitherman] has and does by these presents sell, assign, set over, transfer and deliver, without warranty or recourse, but with full subrogation of all rights and actions of warranty, unto The Ohio Oil Company * * * the following described property * * *:
>
> * * * * *
>
> To have and to hold unto The Ohio Oil Company, its successors and assigns forever, subject to the performance of the terms and covenants in said mineral lease, and payment of rentals and royalties as stipulated in said mineral lease, in so far as same covers and effects that portion herein assigns.
>
> * * * * *
>
> To have and to hold unto the said The Ohio Oil Company, its successors and as-

> signs for and in consideration of the sum and price of three million dollars ($3,000,000.00) cash in hand paid, the receipt of which is hereby acknowledged, and full discharge and acquittance granted therefor, and the obligation of the said The Ohio Oil Company, to pay over and deliver unto the Assignor, his successors and assigns, the sum of One Million Dollars ($1,000,000.00) out of one-half of the first oil produced and saved from the said above-described premises, and subject to the further obligation of the said assignee, its successors, and assigns, to pay over and deliver unto said assignor, his heirs, executors, and assigns, the equal one-eighth (⅛) of all oil produced and saved from the above described premises as an excess royalty, whether produced under the present lease contract or under any extension, renewal, or other contractual obligations entered into by and between the said Assignee, its successors or assigns with the Lessor, his heirs or assigns.

The recited consideration of $3,000,000 was paid by The Ohio Oil Company and the partnership also received the additional $1,000,000 provided for in the agreement. (R. 74.)

In 1919 the George O. Baird partnership through George O. Baird, acting for the partners, acquired a certain oil and gas lease on a then unproved area of land in Claiborne Parish, Louisiana, known as the "Langston Lease." (R. 93.) The partnership drilled a well on the property which resulted in the

discovery of oil on August 23, 1919. The Commissioner of Internal Revenue recognized their right to a discovery revaluation and found the unit value for depletion purposes to be $1.3859 per barrel. (R. 94.)

On November 16, 1921, Baird, acting for himself and the then coowners of the lease (including petitioner), made an agreement with the Gulf Refining Company of Louisiana which was embodied in a written contract. (Exhibit Y, R. 313.) The Gulf Refining Company took possession of the property under the terms of the contract, and as therein provided a deed was executed by Baird and deposited with an escrow agent agreed upon by both parties, to be delivered upon the performance by the Gulf Refining Company of the obligations recited in the contract. The deed remained in the hands of the escrow agent under the terms of the escrow agreement until 1927, when it was delivered to the Gulf Refining Company. (R. 96.)

Petitioner reported as income for 1921 his distributive share of sixty per cent of the seven-eighths of the oil received by Baird from the Gulf Refining Company under the contract with that company (Exhibit Y, R. 96, 97, 313–317), but deducted therefrom depletion based upon the discovery value previously determined by the Commissioner. Petitioner also reported as income for 1921 his distributive share of the income of the Smitherman Special Account partnership, likewise taking a deduction

for depletion based on discovery value. In 1922 petitioner similarly reported his distributive share of the income of the two partnerships and claimed corresponding deductions for depletion. These deductions were disallowed by the Commissioner of Internal Revenue. (R. 53–54, 90, 97, 153–155.)

This disallowance and certain other adjustments resulted in the determination of a deficiency in petitioner's tax of $167,209.92. (R. 195–198.) This sum and interest thereon, the aggregate being $212,937.80, was assessed against petitioner and paid by him under protest on January 4, 1927. (R. 154–155.) This suit was brought to recover that amount. One issue, not involved here, was decided in petitioner's favor and judgment was entered for him in the total amount of $16,723.78. (R. 127.)

ARGUMENT

Petitioner contends that the instruments under which the oil and gas leases in question were transferred are subleases, and therefore the partnerships respectively are entitled as sublessors to deduct depletion. Respondent submits that the Circuit Court of Appeals correctly decided that the instruments effected a sale or assignment of the oil and gas leaseholds, and accordingly the partnerships retained no interest therein which is subject to depletion.

The question presented has been passed upon previously by the Circuit Court of Appeals for the Fifth Circuit and decided adversely to petitioner's

contention, upon identical states of facts, upon petitions of other members of the Smitherman and Baird partnerships to review decisions of the Board of Tax Appeals.[1] *Waller* v. *Commissioner,* 40 F. (2d) 892, and *Herold* v. *Commissioner,* 42 F. (2d) 942. In the *Waller* case this Court denied certiorari. *Waller* v. *Burnet,* 282 U. S. 889.

Petitioner argues that the decisions of the court below are based upon the common-law distinction between sublease and assignment, while under the law of Louisiana these instruments are leases. In support of this argument, petitioner cites *Roberson* v. *Pioneer Gas Co.*, 173 La. 313, decided after the cases of *Waller* v. *Commissioner* and *Herold* v. *Commissioner, supra.* The question before the court in that case was whether a particular oil and gas lease was divisible and had been divided by assignment of a part thereof. It was held that the lease was divisible, that the assignment in question was not a sublease, and that rights which were contingent upon the drilling of a well could not be saved to the lessee by the drilling of a well by the assignee upon the leased premises assigned to him. The court there stated (p. 319):

> The distinction between an *assignment of a lease* and a *sublease* is that, in an assignment, the assignor transfers his entire interest in the lease in so far as it affects the property on which the lease is assigned; whereas, in a

[1] *L. T. Waller et al.*, 16 B. T. A. 574, and *S. L. Herold et al.*, 17 B. T. A. 933.

> sublease, the original lessee, or sublessor, retains an interest in the lease in so far as it affects the property subleased—by imposing some obligation upon the sublessee in favor of the sublessor, such as an obligation to pay additional rent to the sublessor. * * *

There are general statements in the opinion of the court that payment of royalty is payment of rent under the settled law of Louisiana, and that the reservation of an overriding royalty by a lessee in transfering his interest to another characterizes the transaction as a sublease. From these statements petitioner argues that since part of the payments under the instruments in suit are designated royalties, it follows that under the law of Louisiana they are subleases and not assignments. But the statements relied upon were thrown out arguendo and were not necessary to the decision, which was that the transaction under consideration was an assignment and not a sublease. Furthermore the designation of payments as royalties does not necessarily determine their character as such.[2] To call a part of the purchase price of a property right rent would not make it rent or change the position of a vendee to that of tenant. In referring to an obligation to pay royalty or rent as determining the character of an instrument as a sublease, the court undoubtedly meant royalty or rent paid for the use of the property and not a payment which is

[2] See *Murray* v. *Barnhart*, 117 La. 1023; *State ex rel. Bulkley* v. *Whited & Wheless, Ltd.*, 104 La. 125. Cf. *Rives* v. *Gulf Refining Co.*, 133 La. 178.

in fact purchase money fortuitously designated rent or royalty. That this was the meaning of the court seems clear since the basic test laid down by the court was whether the original lessee retains an interest in the leasehold.

This view of the court's language is sustained by what the same court said in *Smith* v. *Sun Oil Co.*, 165 La. 907, upon which the court relied in *Roberson* v. *Pioneer Gas Co., supra.* In *Smith* v. *Sun Oil Co., supra,* numerous writers, on both the common law and the civil law, are quoted. From these authorities it is apparent that the distinction between a sublease and an assignment of a lease under the civil law is not substantially different from the common law. In each case it depends upon the essential character of the grant.

Under the common law, if a lessee grants an interest less than his own, it is a sublease; if he parts with the whole of his interest, it is an assignment. See *Craig* v. *Summers,* 47 Minn. 189; *Stewart* v. *Long Island R. R. Co.,* 102 N. Y. 601; *In re Bayley,* 177 Fed. 522 (W. D. Pa.). In *Smith* v. *Sun Oil Co., supra,* the contract involved was held to be a sublease (p. 912) because the grantor did not dispose of all its rights and obligations under the original lease but granted an interest less than its own and imposed an obligation upon the grantee under penalty of reversion to the grantor (original lessee) in addition to the obligations assumed in favor of the original lessor. When subjected to these tests,

we believe the transactions in question undoubtedly were assignments under either the civil or common law systems.

Petitioner further argues (Br. 44–45) that the decision of the court below conflicts with Articles 2439, 2464, and 2671 of the Revised Civil Code of Louisiana. These articles provide that the price of a sale must be certain and consist of a sum of money. But Article 2464 further provides that "otherwise it would be considered as an exchange." It seems entirely immaterial to the present question whether the transactions be considered sales or exchanges. Since the only question presented here is whether petitioner parted with all of his interest in the depletable property, whether this occurred through means of an exchange or a sale is beside the point. For the purpose of computing taxable gain or deductible loss the same rule applies to exchanges and sales. (Section 202 of the Revenue Act of 1921.)

There seems to be no doubt that under the laws of Louisiana there may be a sale of mineral rights providing for part payment of the purchase price out of the yield of the property. In *Dorcheat Gravel Co.* v. *Herold,* 173 La. 640, the Supreme Court of Louisiana recognized the validity of a sale of sand and gravel, and a plant, for a present sum of money and a further consideration of a royalty to be paid by the vendee of $0.05 per cubic yard for all sand or gravel sold or shipped. Cf. *Wilkins* v. *Nelson,* 155 La. 807, 161 La. 437.

It is submitted that the petitioner and his associates parted with their entire interest in the premises under the respective leases, and that they had no depletable property remaining after the transfer. We believe the decision is correct on this ground, and in this view of the case the other arguments advanced by petitioner are inapplicable.

Those arguments are that the decision of the court below has the effect of holding invalid Article 215 (a) of Treasury Regulations 62, as amended (*infra*, p. 15) and that it is in conflict with *Murphy Oil Co.* v. *Burnet*, 55 F. (2d) 17 (C. C. A. 9th), now pending in this Court on certiorari, No. 80, October Term, 1932.

But Article 215 (as amended) relates only to the allowances and adjustments to be made in the case of a lessor; it makes no provision for a sublessor, who is a lessee with relation to the owner and a lessor with relation to the subtenant. The statute merely provides that the deductions allowed by it shall be "equitably apportioned between the lessor and lessee." Section 214 (a) (10) of the Revenue Act of 1921 (*infra*, pp. 13–14). The Circuit Court of Appeals held that the grantees of the partnerships, who were the operators of the property, are to be considered as lessees and beneficiaries within the meaning of the section providing for equitable apportionment of the allowance between lessor and lessee, and that it would be inequitable to allow depletion on the lump sum payments made to the

partnership or on seven-eighths of the oil produced. The regulation does not cover petitioner's case.

In *Murphy Oil Co.* v. *Burnet, supra,* the question is whether a depletion allowance to a lessor should be deducted from a bonus paid upon the execution of an oil lease or whether it should await the actual extraction. The taxpayer was a lessor, and there was not a third claimant to a depletion allowance. The right to a deduction was not disputed in that case, the controversy being over the time when it might be taken. That question is not in the present case. That case is also distinguishable in that there was no question of equitable apportionment of the depletion allowance.

CONCLUSION

The case was correctly decided below, and there is no conflict with any decision of a circuit court of appeals nor with the applicable local law. The question presented turns on the construction of two particular instruments under local law, and no principle of general application is involved. The petition should be denied.

Respectfully submitted.

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AUGUST, 1932.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * * or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but * * *

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to

March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

Treasury Regulations 62:

ART. 215. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all

the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

ART. 215. [As amended by T. D. 3938 (1926), C. B. V–2, p. 117.] *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

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